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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1937

No. 189

BENJAMIN B. FOSTER AND ROBERT R. TODD, Executors of the Estate of Anna Foster Ford, Deceased,
Petitioners,

vs.

THE UNITED STATES.

REPLY BRIEF FOR THE PETITIONERS.

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REPLY BRIEF FOR THE PETITIONERS.

Opinions Below.

The original opinion of the court below (R. 7-15) is reported in 17 F. Supp. 191. Its supplemental opinion on petitioners' motion for a new trial (R. 15-19) is reported in 18 F. Supp. 790.

Jurisdiction.

The original judgment of the court below was entered December 7, 1936 (R. 15). The order overruling petitioners' motion for a new trial was entered April 5, 1937 (R. 19). The petition for a writ of certiorari was filed July 2, 1937 (R. 19), and granted on October 11, 1937 (R. 20). The jurisdiction of this Court is invoked under Section 3(b) of the Act of February 13, 1925.

Question Presented.

Whether a dividend in 1930 was paid from earnings or profits accumulated after February 28, 1913. This depends upon the effect of a distribution in 1929 in redemption of one-fourth of the corporation's capital stock at a time when there were on hand earnings or profits accumulated both before and after March 1st, 1913. If such distribution (after being charged against paid-in capital behind the shares redeemed) was chargeable against earnings after 1913 before being applied to earnings accumulated prior thereto, such subsequent earnings were exhausted and not available for the 1930 dividend which would then be a distribution from tax exempt prior earnings.

Statute and Regulations Involved.

The pertinent statutory provisions and Treasury Regulations are set forth in the Appendix, *infra*, pp. —.

Statement.

The decedent, who brought suit in the Court of Claims to recover income taxes paid on her return for 1930, died during this litigation and the executors of her estate, the petitioners herein, were substituted as parties (R. 7). The special findings of fact (R. 7 to 11) may be summarized as follows:

On December 10, 1929 the Foster Lumber Company, of which decedent was a stockholder, distributed to its shareholders $1,025,000.00 in redemption of one-fourth of its capital stock, thus reducing the total outstanding stock from 2,000 shares to 1,500 shares. Such reduction was reflected on the books of account as follows (R. 12):

Accounts.	Accounts as of Oct. 11, 1929, before distribution.	Liquidation of ¼ of capital stock.	Balance remaining after distribution.
Capital stock account	$200,000	$50,000	$150,000
Surplus account	4,030,000	975,000	3,055,000

At the time of such distribution the surplus account of $4,030,000 was composed of earnings and profits accumulated after March 1, 1913 in the amount of $330,578.98, the remainder of more than $3,000,000 representing profits accumulated prior to 1913. The court below held that the distribution of $975,000 in surplus should be applied against the earnings accumulated prior to March 1, 1913 and that none of such distribution should be charged against most recently accumulated earnings since 1913. The petitioners contend that the distribution of surplus should have been first applied to the extent of the most recently accumulated earnings of $330,578.98 which would have exhausted such earnings entirely. In that event the earnings available for the subsequent dividend distribution on February 11, 1930 would be only the amount accumulated between October 10, 1929 and February 11, 1930, the sum of $82,758.17.

Argument.

The petitioners having set forth their argument in the petition for certiorari and brief in support thereof, desire at this time to answer briefly the arguments presented in the brief of the United States filed on the merits. This will be done in numbers corresponding to the paragraphs in respondent's argument.

1. *Preliminary.*—This portion of the Government's brief merely sets forth the statute and then argues that Section 115(b) was not intended to deplete earnings since 1913 "by a non-taxable capital exchange upon partial liquidation." At the outset this argument misinterprets the nature of a liquidating distribution under the tax acts. In the first place, a distribution in liquidation is not a non-taxable exchange. It is a distribution of capital paid-in *and* surplus standing behind the stock. In this case, $2,000 per share was distributed in the retirement, consisting of

$100 in paid-in capital and $1900 in earnings and profits. Congress, if it so desired, could have taxed the entire $1900 as a dividend. *Helvering* v. *Canfield*, 291 U. S. 163. On the other hand, Congress could treat such a retirement as an exchange between the corporation and its stockholders and tax to the stockholders only the difference between the amount received and what the particular stockholder had paid for his stock. This is what Congress did in Section 115(c) of the Revenue Act of 1928, but that choice by Congress of the manner of taxing the stockholder does not convert the earnings distributed into "capital" nor is it correct to say that the exchange is non-taxable any more than it is correct to say that a sale of property for cash is a non-taxable transaction simply because the taxability the cost in a particular case is in excess of the cash received.

2. Beginning on page 9 of its brief the United States argues that Congress intended to tax stockholders whenever there were corporate earnings that could have supported a distribution. But it taxes them according to its own rule and subject to its own exemptions. Congress has defined, under Section 115(a), a dividend as a "distribution" consisting only of earnings after 1913 then exempts even such dividends from normal tax, subjecting them only to surtaxes. Sub-division (b) provides that "every distribution" is made out of earnings or profits and from the most recently accumulated earnings or profits. It then provides that earnings or profits accumulated before 1913 may be distributed exempt from tax "*after* the earnings and profits accumulated after February 28, 1913 have been distributed." Coming to Section 115(c) Congress continues to use the word "distribution", so that, unless we are to say that the word "distribution" in sub-division (c) has a different meaning from the same word used in (a) and (b),

the rule of distributing the earnings since 1913 before any distribution is made of prior earnings must apply to all three sections.

We can see no similarity in the present case with cases involving the reorganization of corporations under Section 112 or the stock dividend cases referred to by the United States on pages 10 and 11 of the respondent's brief. It is clear that a reorganization under Section 112 is simply a maintenance of the *status quo* and, in tax effect, carries through the capital stock account and the earnings and profits to the corporation finally resulting. (See *Harter* v. *Helvering*, 79 F. (2d) 12.)

Counsel then argues, on page 14 of his brief, that Section 115(b) is only applicable to taxable dividends. What counsel really claims here is that sub-division (b) has no reference to anything except sub-division (a) which defines taxable dividends as being earnings accumulated after March 1, 1913. This meaning is impossible of acceptance, we submit, because sub-division (b) itself refers to earnings and profits *both* before and after 1913. Furthermore, as pointed out in the brief in support of the petition for certiorari (page 15), it was stated by the Senate Finance Report when Section 115(b) was changed to its present reading as Section 201(b) of the Revenue Act of 1924:

> "Since distributions out of earnings and profits accumulated prior to March 1, 1913 *and* distributions out of capital are in some instances treated differently, it is material to know the source of a given distribution even though all earnings and profits accumulated since February 28, 1913 have been distributed. Consequently, in Section 201(b) of the Bill the presumption that every distribution is out of earnings and profits, applies to *all* earnings and profits whether accumulated prior or subsequent to March 1, 1913." (Senate Report No. 398, 68th Congress, 1st Session, p. 11.)

It would be difficult to find clearer language which directly answers the whole contention of the United States that Section 115(b) has no application to sub-section 115(c) but only applies to 115(a). The Senate amended Section 115(b) in 1924 as above stated to make sure that it applied to "every distribution" whether such distribution accumulated prior or subsequent to March 1, 1913. In so doing it made the same distinction between "capital" and *all* earnings for which we contend.

3. Under this heading the United States suggests an alternative treatment of regarding each share of stock as having behind it a proportional part of the various accounts of the corporation and, accordingly, that the distribution could be considered as changed proportionately against the earnings prior to 1913 and subsequent to 1913. Such a proposal may well have merit as a matter of general logic but it is not the method adopted by Section 115 of the Revenue Act. Section 115(c) provides that the capital account shall be so charged, but that the remainder shall be considered a distribution of earnings or profits within the meaning of subsection (b) which expressly provides, as to "every distribution", that the earnings after 1913 shall be distributed first.

4. Under this Section, beginning on page 18 of the respondent's brief, it is contended that the words "capital account" include earnings and profits earned prior to March 1, 1913. We believe this has been adequately answered in the brief in support of petition for the writ, for, as stated in *Helvering* v. *Canfield,* 291 U. S. 163, such prior earnings are not capital even in the broad constitutional sense, but are earnings or profits expressly exempted by Section 115(b) of the Act. In fact, the Act itself, in Section 115(b), in providing for the exemption from taxation, refers to such prior earnings as "any earnings or profits

accumulated • • • before March 1, 1913." Surely, when Congress itself, in the very section under question, referred to such prior earnings as "earnings or profits" it cannot be said that Congress intended them to be capital even in the loose sense which counsel suggests.

Conclusion.

Section 115 of the pertinent Revenue Act provides for

1. A distribution of earnings or profits most recently accumulated. This is a taxable distribution of the earnings or profits accumulated subsequent to February 28, 1913.
2. A distribution of earnings or profits accumulated before March 1, 1913. This is a non-taxable distribution.
3. A distribution in complete or in partial liquidation. This shall be treated as in part or full payment in exchange for the stock.

The essence of this appeal is that "every distribution" is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Under the plain language of the statute the intention is clear to first exhaust earnings that are taxable as dividends. Par. (c) of Section 115 makes an exception when the distribution is in partial *liquidation*. It provides that the *part of such distribution* which is *properly* chargeable to *capital account* shall not be considered a distribution of earnings or profits. The word "liquidation" contemplates and comprehends the retirement of outstanding capital stock. The words "capital account" similarly and exclusively contemplate and comprehend the outstanding capital stock on the books of the corporation. To the extent that a distribution is *properly* chargeable to this cpaital account it "shall not be considered a distribution of earnings or profits."

In the instant case, in the distribution and liquidation of October 10, 1929 (R. 12) one-fourth ($50,000.00) of the amount was *properly* charged to "capital account". This was the par value of one-fourth of the capital stock outstanding. To this extent the distribution "shall not be considered a distribution of earnings or profits." And so, the United States Board of Tax Appeals held in *Helvering* v. *Craig, etc.* (see Appendix B in the petition for certiorari) that

> "* * * the distribution of October 10, 1929 must be marshalled first against the capital to the extent of the par value of the 500 shares of stock redeemed and retired, then against the earnings after February 28, 1913 which were on hand October 10, 1929."

The judgment of the Court of Claims should be reversed.

Respectfuly submitted,

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Counsel for Petitioners.

APPENDIX.

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of dividend.*—The term "dividend" when used in this title (except in section 203 (a) (4) and section 208 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

(b) *Source of distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the basis of the stock provided in section 113.

(c) *Distributions in liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed in partial liquidation (other than a distribution within the provisions of section 112 (h) of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of subsection (b) of this section for the pur-

pose of determining the taxability of subsequent distributions by the corporation.

* * * * * * *

(h) *Definition of partial liquidation.*—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

Treasury Regulations 74:

ART. 622. *Source of distribution.*—For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits.

ART. 623. *Distributions out of earnings or profits accumulated, or increase in value of property accrued, prior to March 1, 1913.*—Any distribution by a corporation out of earnings or profits accumulated prior to March 1, 1913, or out of increase in value of property accrued prior to March 1, 1913 (whether or not realized by sale or other disposition, and, if realized, whether prior to or on or after March 1, 1913), is not a dividend within the meaning of Title I. A corporation can not distribute earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, exempt from tax, unless and until all earnings or profits accumulated since February 28, 1913, have been distributed. Whenever one corporation receives from another corporation distributions out of earnings or profits accumulated by such other corporation prior to March 1, 1913, or out of increase in value of its property accrued prior to March 1, 1913, and the "receiving" corporation, after having first distributed all of its earnings and profits accumulated since February 28, 1913, distributes to its shareholders the amount so

received by it from such other corporation, the distribution by the "receiving" corporation to its shareholders is not a dividend within the meaning of Title I and is exempt from tax.

In determining whether a dividend is out of earnings or profits accumulated since February 28, 1913, or prior to March 1, 1913, due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive.

* * * * * * *